



Finance And Economics: Chasing the leader; Economics focus

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Abstract:

America has been the world's economic leader for over a century. Economic theory suggests that western Europe should be catching up. Yet average GDP per head in the European Union, measured at purchasing-power parity, is only three-quarters of that in the United States. A popular explanation is that European firms are less productive because they are hampered by labour- and product-market regulation. But European productivity, measured by output per hour worked, has in fact almost caught up with America's. However, Europeans are apparently much poorer than Americans. Robert Gordon suggests that perhaps half of the current gap in living standards between America and Europe, as measured by GDP per head, is illusory. Add in the value of their extra leisure time and Europe's living standards are now perhaps only 8% behind America's, he suggests, not the 23% suggested by official data. Indeed, on Gordon's broader measure, Europeans' productivity may have overtaken that of their poor American cousins.

Full Text:

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Are Europeans really so much worse off than Americans?

AMERICA has been the world's economic leader for over a century. Economic theory suggests that western Europe should be catching up. Yet average GDP per head in the European Union, measured at purchasing-power parity, is only three-quarters of that in the United States. A popular explanation is that European firms are less productive because they are hampered by labour- and product-market regulation. But European productivity, measured by output per hour worked, has in fact almost caught up with America's. If Europeans are so productive, though, why are they apparently so much poorer than Americans?

America's much-trumpeted "productivity miracle" in the late 1990s created the misleading

impression that Europe significantly lags America in the productivity league. It is true that, since 1995, American GDP per hour worked has risen by an annual average of 1.9%, compared with only 1.3% in the European Union. However, over any longer period, up to half a century, Europe's productivity growth has outpaced America's. Since 1990 American productivity has risen by 1.6% a year; the EU's has risen by 1.8%. Since 1950 America's productivity growth has averaged 2%, Europe's 3.3%. According to figures from the Conference Board, an American business group, Belgium, France, Germany, Ireland and the Netherlands all now boast higher output per hour than the United States. Average productivity in the EU is still 7% less, largely because of lower productivity in Britain, Spain, Greece and Portugal--but the gap has continued to close over the past decade.

The narrowing of the productivity gap has not, however, been reflected in living standards, as measured by GDP per head. The chart, taken from an analysis* by Robert Gordon, an economist at Northwestern University, shows how Europe's productivity and GDP per head fell relative to America's from the mid-19th century until around 1950. Productivity has since rebounded, almost reaching American levels. GDP per head, on the other hand, rose sharply until 1970, but then flattened off at 77% of America's.

The surge in Europe's productivity since 1950 is largely explained by reconstruction after the war and the belated exploitation of electricity and the mass production of cars--40 years after America. The puzzle is why Europe's GDP per head has lagged so far behind productivity. Germany's GDP per man-hour is 1% higher than in America, but its GDP per person is 25% lower. The main reason is that average hours worked in Europe have fallen so sharply. In part, this reflects an increase in unemployment and withdrawals from the labour force; but it also reflects a preference for shorter working weeks and longer holidays.

A broader analysis of living standards, based on economic welfare rather than crude GDP, argues Mr Gordon, would place some value on Europeans' greater leisure time. But how much of the depressing effect of shorter hours on Europe's GDP per head should be ascribed to people's free choice to take longer holidays than overworked Americans, and how much to union pressure or government policies that try to spread jobs by compulsory limits on hours of work? Mr Gordon guesses that one-third of the discrepancy between Europe's productivity and its GDP per head, relative to America's, represents freely chosen leisure. Corrected for this, Europe's income per head is not 77% (the official figure) but 82% of America's.

200 ways to say cheese

Mr Gordon does not stop there. After adjusting GDP per head for extra leisure time, he then attacks GDP itself. Mr Gordon argues that GDP comparisons tend to overstate America's living standards and understate Europe's. For example, America's climate is more extreme than western Europe's, so more has to be spent on air conditioning and heating to attain a given indoor temperature. This extra spending boosts GDP, but does not enhance welfare. More of America's GDP is also spent on home and business security--largely because of a higher crime rate. In most of Europe, such spending is less necessary. The huge cost of keeping 2m people in American prisons (a far bigger proportion of the population than in Europe) also bolsters America's GDP relative to Europe's, but not its welfare.

Another factor is the greater dispersion of America's population in vast, sprawling metropolitan areas with few transport options other than the car. This is partly the result not of private choice but of public policy, such as subsidies to suburban motorways and a starving of public transport, or local zoning laws that limit the minimum size of residential developments. It leads to higher spending on roads and energy, and hence higher GDP. In Europe the convenience of more compact cities and frequent train and bus transport does not count towards GDP figures.

More contentious still, Mr Gordon suggests that we take account of the value that the French, say, place on variety. They protect small, local shops so that they can buy 200 kinds of cheese. Americans might retort that their gourmet supermarkets carry cheeses from all around the world, but Mr Gordon (an American, remember) argues that most Americans have to drive a long way to these stores and they exist only on the edge of big, well-off towns. GDP ignores such welfare comparisons.

Taking account of how Americans waste a chunk of their income on heating, air conditioning, prisons and the like, while also attaching value to Europe's superior public transport, Mr Gordon suggests that perhaps half of the current gap in living standards between America and Europe, as measured by GDP per head, is illusory. Add in the value of their extra leisure time and Europe's living standards are now perhaps only 8% behind America's, he suggests, not the 23% suggested by official data. Indeed, on Mr Gordon's broader measure, Europeans' productivity may have overtaken that of their poor American cousins.

* "Two Centuries of Economic Growth: Europe Chasing the American Frontier". Available at <http://faculty-web.at.northwestern.edu/economics/gordon/355.pdf>

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